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OFFICE OF ANALYSIS FOR EAST ASIA AND THE PACIFICCHINA LIGHTS**EXCISE** P
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Note to Readers: To promote timeliness and efficiency, INR/EAP will replace China Lights in the new year with a new "INR China Analysis" series by cable. Each cable will contain one report; our intent is to speed up the distribution of our analyses to posts. Also, as appropriate, we hope our new series will give officers overseas more timely and useful information for sharing with diplomatic colleagues and questioning Chinese contacts.

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I. CHINESE VIEW US TRADE PRESSURE, PREPARE FOR THE WORST (12/20)

In a reprise of their early 1991 MFN strategy of "hoping for the best, preparing for the worst," Chinese leaders before the Secretary's Beijing visit decided to allow US-China ties to cool while improving links with Europe. Leaders are increasingly pessimistic about resolving trade strains with the US, foreseeing "301" sanctions and possible MFN loss. In this context, they seem willing to test US resolve and punitive intent by chancing IPR retaliation.

The Chinese may be encouraged in this approach by the lack of European pressure on China over trade and proliferation issues.

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Strategy in trade talks PRC Trade ministry officials blame US-PRC political strains, particularly those related to human rights, for toughening the US stance toward China. They apparently believe the US is treating China more severely than it is other trading partners.

[REDACTED]

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Dragging out talks... Going into the late-December round of IPR talks, Chinese officials believed the US had ignored "substantial" Chinese progress toward improving IPR protection and reacted to Chinese concessions only by making more demands. Trade ministry officials believed the US would soften its "hard" stance during the December negotiations and extend the IPR investigation another six months. The Chinese planned to shape their final negotiating position for a last scheduled Washington IPR round in January only after listening to the US presentation in the December round.

...while preparing for the future. In the meantime, China reportedly has begun a number of steps to cushion future US retaliation or trade friction. It plans to step up efforts to export to West Europe, the former European communist states, and untapped Third World markets.

[REDACTED]

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Chinese local textile firms have been setting up production facilities in third countries, [REDACTED] in order to take advantage of those countries' US import quotas.

(CClarke) (SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

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II. TAIWAN: A WATERSHED ELECTION (12/21)

In Taiwan's first democratic elections for the full membership of a national-level representative body, voters are today (December 21) selecting National Assembly members, whose sole task is to revise the constitution. Despite the brouhaha over opposition calls for Taiwan independence, most voters have shown little interest in the issue. The organizationally superior ruling party appears poised for a convincing victory, but the election will nonetheless shift power to a new generation and from mainlanders to Taiwanese.

The election is an important step in the transfer of power from a rapidly expiring gerontocracy of mainlanders in place since 1947 elections on the mainland to the Taiwanese majority. Attrition and Taiwanese protests finally forced the Kuomintang (KMT) to reorganize the assembly as a body representing the people of Taiwan. To appeal to voters in local elections, the KMT since the 1950s has promoted bottom-up Taiwanization, and most of its candidates now are Taiwanese.

The opposition Democratic Progressive party (DPP), allowed only since 1986, is almost totally Taiwanese. The more established KMT has used its clear advantages in money, organization, and ties to local power brokers to stay in power; the weaker DPP has been unable to attract new voters with its pro-independence stance. That Taiwanese are increasingly gaining control of their own destiny is probably undercutting the appeal of the independence movement.

Getting the voters' attention. Most voters today will be more concerned by which faction or family a candidate represents than by independence or the esoteric issues of constitutional revision or governmental change. Only direct election of the president, which the DPP favors, has drawn substantial voter interest. Because the KMT has purposely waffled on direct elections, however, the DPP has been unable effectively to capitalize on the issue. In some areas candidates are promising economic benefits they cannot deliver.

No contest. No matter how well the DPP does, it will fall far short of the KMT because it has fielded candidates for fewer than half the contested seats. The ruling KMT has many levers to keep itself in power. In addition to advantages in size, organization, and finances, the KMT dominates the media, especially television. With its control of the government and military, the KMT can mobilize numerous campaign workers and voters, and government decisions on election-related matters invariably favor the KMT.

In its campaign strategy, the KMT focused on DPP independence advocacy, presenting itself by contrast as a moderate, responsible party committed to the status quo and "reform, stability, and prosperity." Sensibly, the KMT has not campaigned for reunification.

KMT dominance notwithstanding, the DPP can count on a solid base of minority support and will probably win enough seats in the assembly to ensure a voice in constitutional revisions, which must be passed by a 75% majority.
(MFinegan) (CONFIDENTIAL)

III. TAIWAN INDEPENDENCE MOVEMENT (12/21)

Despite heated rhetoric from both the PRC and the Kuomintang (KMT) following the Democratic Progressive Party's (DPP) October adoption of an independence plank, support for de jure independence is weak. Beijing has acknowledged Taipei's renewed commitment to oppose independence, and conflict beyond verbal sparring is unlikely.

Calls for Taiwan independence have become more prominent recently as a consequence of electoral competition between the KMT and the opposition DPP, DPP factional infighting, the return of overseas independence activists, and the freer atmosphere brought by democratization. Only a small (and fairly stable) minority--polls suggest support in the 10-20 percent range--of Taiwan residents favor outright independence; most fear PRC wrath if independence were declared and favor the safer course of maintaining the status quo.

Armed conflict between the PRC and Taiwan is highly unlikely; PRC rhetorical anti-independence blasts are designed largely to bolster the KMT's anti-independence stance and intimidate would-be independence supporters. The PRC will be reluctant to use force or overdo its threats, fearing damage to its international standing and economic development plans, an uncertain US reaction, and an undermining of its efforts to peacefully entice Taiwan.

The Kuomintang won a substantial victory in the December 21 National Assembly elections, taking 71 percent of the popular vote, substantially better than its 60 percent showing in 1989 elections. Unable to attract new voters with its pro-independence stance, the DPP won only 24 percent of the vote, down from about 30 percent in 1989. Although the KMT may characterize the results as a rejections of independence by the Taiwan electorate, in fact, the election was determined more by KMT advantages in money, organization, and control of local factions.

The KMT will not abandon its opposition to Taiwan independence. Maintaining the "ROC" name and rejecting Taiwan independence are fundamental principles, and conservative mainlanders most committed to "one China" continue to be an important force in the party. Arguing that Taiwan is already independent as the "ROC," the KMT says calls for Taiwan independence are superfluous.

PRC policy toward Taiwan emphasizes peaceful exchanges and negotiations aimed to achieve eventual unification. To keep the independence movement in check, Beijing refuses to rule out the use of force. Even at the height of rhetorical outbursts in reaction to independence-related developments in Taiwan, however, Beijing has shown no signs of altering its basically peaceful policy in favor of a more militant approach.

As long as the KMT retains control, Taiwan will be able to manage both the independence issue and relations with the PRC. Although unlikely, future PRC-Taiwan problems could occur if the KMT were discredited and the opposition came to power, or if a popular opposition leader with strong Taiwan nationalist credentials were elected president. Even in such cases, however, both Taiwan and the PRC would seek to avoid actual conflict. (MFinegan) (SECRET)

IV. CHINA/RUSSIA/KAZAKHSTAN: CATCHING FALLING STARS (12/25)

Chinese leaders are watching Soviet dissolution with deep unease but are beginning to forge ties with Russia and Kazakhstan. Not surprisingly, conservatives and reformers have drawn different lessons for China from the Soviet collapse.

Dismayed by the Soviet collapse, Chinese leaders have publicly voiced concern over control of the Soviet nuclear arsenal and a possible flood of refugees. In private they express fears of revived Russian nationalism and of ethnic unrest spreading to China; Beijing has increased military readiness and stepped up security measures to control ethnic minorities in border areas.

The Soviet breakup has ambiguous military, political, and economic consequences for China. Leaders see a long period of turmoil akin to China's Cultural Revolution, with continued economic decline, growing civil unrest, and the likelihood of further coup attempts. Not wanting to hasten the Soviet breakup, Chinese leaders held back from building ties to new republican leaders; they gratuitously snubbed Yeltsin and, until two weeks ago, dealt with the USSR government on border issues.

Dealing with the republics. China's interest in the republics, originally stimulated by Taiwan's activist diplomacy toward these emerging targets of opportunity, has now taken on great urgency. Beijing announced December 24 it was ready to establish relations with the new commonwealth republics, and it will probably do so just after Gorbachev resigns; it recently welcomed a representative of Yeltsin [REDACTED] 61

This week it signed a new trade pact with Kazakhstan [REDACTED]

[REDACTED] Fearing Turkic nationalist contagion from Central Asia, Beijing is unlikely soon to welcome consular missions in Xinjiang.

China's leaders remain uncomfortable dealing with the republics and their apostate communist leaders, and continue to hedge their bets. Xinhua, for instance, has consistently reported evidence, not highlighted by western media, of a

possible revival of communist fortunes. [REDACTED]

Lessons for China. Chinese leaders interpret Soviet collapse as evidence their own economic reform policies and "resolute measures" to resolve the Tiananmen "turmoil" saved China from chaos and western subversion. They dissociate China from the USSR and stress the uniqueness of Chinese communism and its nationalist roots, to counter any popular notion that communism's days in China are numbered. But [REDACTED] an almost non-stop round of meetings in recent weeks on Soviet developments to fix the "lessons" for China. Conservatives and moderates draw opposing conclusions. Conservatives maintain that political reform caused the CPSU's downfall and argue for greater ideological discipline; moderates, [REDACTED] assert the CPSU collapsed because its leaders lost touch with the masses, and argue for continuing, even intensifying, reform in China. (JHuskey) (~~SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS~~)

V. CHINA/MIDDLE EAST: DIFFERENT STROKES FOR DIFFERENT FOLKS
(12/18)

Relegated to the bleachers in the Arab-Israeli peace process and cornered into reluctant participation in the Middle East arms control talks, China is using a hodgepodge of pragmatic--sometimes blatantly opportunistic--initiatives to build friendly ties and arms sales in the region, and boost its global stature.

China's finesse in navigating the Middle Eastern shoals is apparent in its extensive arms sales. Chinese arms dealers hawk their wares in a number of capitals, selling an array of weapons and military technology [REDACTED]

[REDACTED] During the Iran-Iraq war, China sold weapons to both sides and to Saudi Arabia, which bought CSS-2 missiles as a deterrent against Iranian Scuds. It has continued to offer weapons to conservative [REDACTED] and radical [REDACTED] Islamic states [REDACTED]

Limits to credibility. Three top Chinese leaders have visited key Middle East countries since the Gulf war, and China has also edged toward normalization with Israel. Only Iraq has been left out in the cold [REDACTED]

[REDACTED] By staying
distantly in step with the West and its wartime allies, China
has hoped to position itself as a responsible force, while
staying out of regional rivalries. Until recently China
successfully avoided antagonizing key regional states; its
equivocal position during the Gulf war and its post-war arms
sales efforts have begun to damage its credibility.

Tehran ties irk Saudis. The November visit to Tehran by
Chinese President Yang Shangkun, together with widely reported
nuclear supply sales and diplomatic rumors of an incipient
Tehran-Islamabad-Beijing alliance have raised eyebrows in Saudi
Arabia and elsewhere. The Saudis [REDACTED]
[REDACTED] prefer that China refrain
from missile, nuclear, and major conventional arms sales to Iran
and Syria. [REDACTED]

[REDACTED] It may also be ready to
believe rumors that China is interested in a special
relationship with Iran.

Israel, not a problem. [REDACTED]

[REDACTED] China has now slowly and
carefully warmed up and publicized its "unofficial" relations
with the Tel Aviv. In the past year there have been several
reciprocal visits below the cabinet level, and the level of
representation in both capitals has been raised. In late
November China did not mind having Israeli Defense Minister
Arens photographed on the Great Wall during an ostensibly
private visit. All indications are that formal diplomatic ties
are just a matter of time. China has done the minimum necessary
to balance its moves toward Israel; it absented itself from the
UN vote overturning "Zionism is Racism" and has invited PLO
leader Arafat to visit Beijing.

Low-cost engagement. Despite the apparent contradictions in
its approach, China has been relatively successful in balancing
opposing forces and demands. As it shifts from formerly cheap
rhetorical support for the Arabs against the Israelis to more
complex political, economic, and security relations in the
region, China will avoid alliances and be open to multilateral
mechanisms it can use to amplify its global influence.
(JHuskey/NSilver) (SECRET/NOFORN/NOCONTRACT/ORCON/EXDIS)

VI. CHINA/SOUTH ASIA: ADJUSTING TO CHANGE (12/24)

Chinese leaders are balancing conflicting goals in South
Asia: maintaining strong military ties with Islamabad without
incurring proliferation-related US sanctions, improving
Sino-Indian relations without damaging ties with Pakistan, and
utilizing widely shared concerns about post-Cold War "US
hegemony" to boost Beijing's influence without further straining
US-China relations.

Exchanges between Chinese and South Asian officials have occurred often in recent months, including President Yang Shangkun's October trip to Pakistan and Iran, Premier Li Peng's December visit to India, and numerous trips to Beijing by lower-level delegations from the region. Increased intercourse with South Asia is part of Beijing's post-Tiananmen effort to assure stability around its borders during troubled times.

China also has been probing for new opportunities arising from the Soviet drawback from India and strained Pakistani-US relations, and assessing new risks, including US pressure on proliferation and improved US-Indian ties.

Shared Concerns. Recent Chinese exchanges with South Asia have evinced shared concern over the emerging new world order; joint statements have focused on demands for equality of nations, non-interference in other countries' internal affairs, and on non-interference in other countries internal affairs, and on definitions of human needs over political or procedural rights. In seeking common cause with such diverse states as Iran, Pakistan, and India, Beijing seeks to balance--not challenge outright--US leadership in defining the post-Cold War order.

Proliferation. China, Pakistan, Iran, and India share antipathy to Western pressure on proliferation and technology transfer. But Beijing seeks to boost its influence and earn hard currency from arms sales, without losing the US market or forfeiting access to western high technology through sanctions. Thus Chinese officials likely are seeking ways to fulfill both their obligations to Islamabad under existing missile agreements and their pledges to the United States to abide by MTCR guidelines.

Balancing Ties. After a three-year hiatus, Li Peng's visit to New Delhi earlier this month resumed the progress in improving relations begun by Prime Minister Rajiv Gandhi's 1988 trip to Beijing. Beijing sees advantages in warming Sino-Indian ties: reducing border tensions, fostering greater trade and technology sharing, and, perhaps, gaining greater Indian cooperation in restraining political activities of Tibetan exiles. Beijing has taken pains to assure Islamabad that improved Sino-Indian ties will not come at Pakistan's expense.

Indeed Beijing hopes to take advantage of strained US-Pakistani relations to strengthen its own influence and boost military sales. But Beijing recognizes it must move carefully to avoid further damage to US-China relations. And it will also continue to resist being drawn into bilateral conflicts such as the Indian-Pakistani dispute over Kashmir. Regionally, China may chose to play a greater role on a South Asia nuclear-free zone, but only as long as it does not limit China's own nuclear deployments. (CClarke) (CONFIDENTIAL)

VII. CHINA: REASSURING FARMERS, PRODDING CADRES 12/27)

China's recent Communist party plenum published a decision on rural policy that sought to reassure farmers that the popular family-based farming policies will continue; it also addressed perceived problems including slowed growth in grain output, crumbling rural infrastructure, recent slumps in rural income, and declining law and order in the countryside. The prescriptions included wider use of markets, expansion of local government and collective services and infrastructure development, and bolstering the party's control in the face of growing challenges.

Last summer's devastating floods added urgency to an ongoing reassessment of China's decade-long rural reforms. The only major policy decision at the party's eighth plenum, on November 25-29, was to pass a document on agricultural policy and party work in the countryside. One rural policy expert had told Embassy Beijing before the plenum there would not--and should not--be any major changes; China's rural reforms have reached a point from which progress will only be incremental.

Family farming remains the base. Throughout the reform decade, and especially since Tiananmen, leaders have sought to assure farmers that the family contracting system will not be changed. Seeking to allay fears of possible future recollectivization. Vice Premier Tian Jiyun recently termed the household system the "most basic" rural policy and the "hallmark" of China's reforms; he said the target of rural reform was to expand the scope of market regulation, reduce subsidies, and free most prices. Now, unlike the past, virtually no leader or government agency opposes agricultural price reform, according to rural policy experts.

Tian and other leaders nonetheless emphasize that China has not, and will not, privatize land, and that farmers are required to pay taxes, deliver contracted grain at state-set prices, and pay land lease fees to the collective. Some areas are reclaiming land from peasants who have abandoned farming for rural industry or other pursuits; the land is re-leased to households or collectives.

Expanding "socialized services". Since the late 1970s, local governments have focused on industrialization at the expense of refurbishing rural transport, water conservation works, and forestry, and have been slow to promote supply and marketing services, mechanization, irrigation, and popularization of agricultural science and technology.

Beijing has been pushing for expanded collective organization and higher local funding for such programs, but Tian recently warned such expansion must not be allowed to weaken family farming.

Bolstering the party. The household contract system prompted a decade-long decline of party fortunes in the countryside; many cadre took advantage of reforms to enrich themselves. The party's prestige suffered, clan organizations reemerged, religious belief spread and superstitious practices reappeared, and criminal activity flourished, all seen by the regime as threats to its control.

Beijing is now trying to strengthen the party by defining its mission as fostering the collective good through managing socialized services, spreading science and technology, facilitating industrialization, and assuring law and order. (CClarke) (CONFIDENTIAL)

VIII. CHINA: CENTER RENEWS FIGHT FOR MORE RESOURCES (12/22)

China's state council passed a new budget law this fall to take effect on January 1. It codified budgetary changes instituted during the 1980s and includes measures to improve fiscal discipline and increase the center's claim on resources. A gradual tax reform has also been announced to simplify and make more equitable China's complex tax system. Implementing these reforms will reignite fighting among central, provincial, and local governments over how much is collected, from whom, and who gets to keep it.

Awash in red ink. Booming industrial output up 14% during January-October compared to the same period last year has been accompanied by an increase of only 10% in retail sales, and unsold stocks amounted to \$38 billion by the end of September. More than a third of state-owned industrial firms were in the red at mid-year, and losses remained high in the third quarter. State wholesalers are in trouble, too, hampered by having to buy unsalable planned production and sell much of their desirable stock at fixed prices. Despite large credit infusions, enterprise debt remains high and cash short; tax arrears reached about \$4 billion by the end of September.

Finance Minister Wang Bingqian has already indicated this year's budget deficit will be substantially above last year's nearly \$10 billion record. Budget outlays have exceeded lackluster revenue growth in part because of increased producer subsidies and flood-related expenses.

Budget headaches promise to be worse next year, when domestic debt service and payments will more than double, to \$6.9 billion. The crunch in bond payments may foster progress: next year the government plans to expand its bond sales through financial firms and underwriters and permit greater trading in a fast expanding network of primary and secondary markets.

Modest fiscal reform. Despite years of debate over budget reform, the new law--the first since 1951--breaks little new ground; for example, it adopts few of the World Bank's numerous recommendations. It divides outlays into current and capital expenses and permits borrowing only to fund construction undertaken by the center. All other budgets are required to balance.

The new law retains the system of classifying revenues and expenditures as central, local, and shared, but the finance ministry gains greater authority over drafting the final, unified budget. Once the center's macroeconomic concerns are satisfied, localities will have fiscal autonomy and can retain any year-end surplus.

The law forbids shifting income off-budget or shifting non-budget expenses to the budget, techniques local officials have exploited in recent years to reduce the center's take. Until specific measures are adopted to divide funds and obligations between levels of government, existing fiscal contracts that fix the contributions to the center by firms and provinces will remain in force.

Renewed battle over resources. The battle probably was joined at planning and finance conferences held in early December. At last year's conferences provincial officials successfully beat off Beijing's efforts to recentralize fiscal control. This year Beijing was able to bring to the table a newif weakweapon in the form of the budget law, and a persuasive argument that it not only needs more resources but has taken needed action to reduce its subsidy expenses. Wealthy provinces, however, would have resisted any pressure to increase their payments to the center. (INR/EC:WNewcomb) (CONFIDENTIAL)